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Economic Conditions
Governmental Finance
United States Securities

New York, March, 1937

General Business Conditions

THE current trade reports show that business is making a good recovery from the brief setback in January, which was caused chiefly by the automobile and shipping strikes and the floods in the Ohio Valley. A strong rebound after interruptions of this kind is natural. They block the shipment of goods on order and cause purchases to be deferred, and when business is resumed there is a rush to fill urgent needs. Even those who experienced losses in the floods may for a time spend more than usual; they will buy less of some things but they have to replace household and personal goods destroyed, and the purchasing power to make these replacements will come out of savings, borrowings or relief contributions. The same is true of business concerns. The first necessity is to repair the damage to transportation facilities and plant equipment, and to clean up and get to work; and for the most part going concerns can find the money they need out of reserves or loans.

Thus the floods will lead to a good deal of expenditure on labor and materials not previously planned, and reports from the areas affected already show the stimulus. In Cincinnati retail and wholesale trade and bank clearings by the second week in February were showing large gains over a year ago. The recovery in Louisville, where the floods were later in receding and the restoration of electric power service presented special difficulties, was proportionately prompt.

Settlement of the General Motors strike on February 11 was followed by quick resumption of operations, and the Corporation expects to have its assembly lines running at capacity early in March. Of course General Motors will run full for several months. It is far behind schedule in stocking its dealers for the Spring season, and unfilled orders are correspondingly heavy. Meanwhile other producers have been selling cars as fast as they can turn them out. Preliminary figures of new car registrations for January indicate a gain of 31 per cent over the same month last year, a remarkable showing in the circumstances. Also, it is significant as to consumer purchasing power and willingness to spend. With the Spring demand for cars now beginning, capacity operations for the entire industry are assured for a considerable time. The flow of steel, glass, and other materials and parts into the automobile plants is on the increase accordingly.

The end of the West Coast shipping strike is another favorable development. It releases for shipment merchandise and raw materials which in some cases have been tied up for several months, and permits trade to go ahead normally.

Making Up Lost Time

In important areas, therefore, business has to make up lost time, and the general situation will be supported accordingly. The trend is usually upward at this season, due to the opening of outdoor work and the influence of Easter and warmer weather on trade. Moreover, the way is clear again for the influences that were carrying business forward before the interruption. It is plain that there has been no real slackening in the momentum of recovery. The capital goods industries are still on the rise, and they are setting the trend. Building contract awards, railway and utility equipment orders, farm implement sales and machine tool purchases have all run substantially ahead of the 1936 figures, with residential building and railway purchases more than twice as great and machine tool orders not far behind.

The steel industry has pushed its production rate up a few points more, partly to meet General Motors' requirements, and partly to satisfy the strong demand from other consumers. Steel mills in January, averaging 81.4 per cent of capacity, turned out a larger ingot tonnage than in any previous January; and operations are now approaching 85 per cent, which is close to the practical limit until more furnace repair and reconstruction work is done. Even with this output the demand

for early deliveries is pressing. Doubtless precautionary buying against the possibility of a strike is a factor in the high production, but it is difficult to find accumulations of steel; evidently the protective orders are for the most part still on the manufacturers' books, waiting to be filled.

In the industries making goods of everyday personal use there is less room for expansion than in the heavy lines, for many of them have been operating for some time at boom levels, and in due course may find it prudent to slacken their production. At present, however, these industries are working against well-filled order books, sufficient to keep them going. Cotton goods sales have been slower during February and prices easier in some divisions, but the mills have no worries for the near future, and will have to keep production at a record rate to get out the goods already sold. Woolen mills have large backlogs of orders, and rayon yarn producers are selling their capacity output without trouble. Silk consumption is running above a year ago. Shoe business has been good, and production will continue heavy.

Retail trade is running above last year by 12 to 15 per cent on the average. Wholesale buying is up proportionately. Merchants expect to show a similar gain in their Easter business, and have good reasons for confidence. The facts above given show that unless major strikes interfere the outlook for employment and payrolls and the buying power of labor is very favorable. Farmers also will have a high purchasing power. The Department of Agriculture continues optimistic in its comments on the trend of farm income; it foresees for the near future a strong consumer demand and firm prices, as well as larger payments to farmers out of the Treasury, under the soil conservation program, than was the case a year ago.

Labor Troubles

The chief uncertainty in the outlook is the possibility of continuous harassing strikes and minor labor troubles, such as are now being experienced, and even of shutdowns in major industries. Most of the sitdown strikes are short-lived and they affect only a minority of labor, but in the aggregate they handicap business considerably, and their prevalence tempers the general optimism. The danger of one or more great strikes in the Spring, in steel, bituminous coal and possibly other industries, or a recurrence of the automobile troubles, is a greater menace. They would halt production, stop the flow of purchasing power around the circle, and cause a scramble for goods and costly price advances.

Temporarily the strike threat tends to increase industrial activity, as the industries threatened receive precautionary orders and speed up their production to fill them. Fear of interruption of shipments is a factor in forward buying in a good many lines. Of course no one is under illusion that such a stimulus to business is beneficial. The buying is at the expense of the future, and is in last analysis an element of instability.

With the recovery running strongly, incomparably the greatest interest of everyone is to keep the progress orderly and balanced. Everyone wants to see the productive facilities of the country turning out all the goods and services of which they are capable, and the unemployed back to work. It is certain that the trend is in that direction, and that it will continue so as long as it is not menaced by fresh disturbances in business and trade relations. On the other hand, if the development is uneven, and if because of labor demands or for any other reason costs and prices of various classes of goods get out of line, the upward movement will come to a halt because the ability of some groups of the population to trade with others will be impaired.

Price Trend Upward

The trend of prices of manufactured goods is now strongly upward, due to rises in wages and raw materials, Social Security costs, and the strong demand. Price advances noted during the past month have been in shoes, clothing, tires and blankets, and others are in prospect, especially as a 12 per cent wage increase has been granted to clothing workers and 15 per cent to New England shoe workers. Retail prices of department store merchandise on February 1 were over 5 per cent over a year earlier, according to the Fairchild index, and a greater rise this year is looked for in all quarters.

Steel manufacturers have told their employes that they will not raise prices generally without increasing wages, and that they cannot raise wages without increasing prices. Iron Age on February 25 made the following statement with reference to steel prices:

> A price advance affecting nearly all steel products and probably ranging from $2 to $6 a ton will be announced by a leading producer within a few days. This may be followed by another wage increase for steel mill labor.
>
> Price advances have been initiated by producers of wire products and pig iron. Nails and staples have been put up $5 a ton, barbed wire $6, heavy fence wire $4, light fence wire $6 and bale ties $3, effective immediately and without contract privilege.
>
> A leading merchant furnace interest announced an advance of $1 a ton on pig iron, effective at once, and other producers in all important districts have taken like action. Beehive furnace coke is up 25c a ton at Connellsville to $4.25, and scrap is higher in all markets. The Pittsburgh range on No. 1 heavy melting steel is $20.50 to $21, and leading factors in the scrap trade freely predict a $25 market.

It may be argued that the strength of the demand is evidence that these price increases can be easily absorbed, and certainly this

seems at present to be true. However, business men are interested not only in the few months ahead, but in the soundness or unsoundness of long trends, and this argument raises many broad questions.

All those who do not have increases in wages and salaries will suffer from price advances. Farm income is still on the rise, but it is far from certain that the equilibrium now existing between agricultural and industrial prices is on a sound and lasting basis. The most important influence in restoring the balance was the series of short crops which cleared away the agricultural surpluses and raised farm prices. Now greater acreages are being planted or prepared, including a record area to wheat and probably an increase in the cotton and tobacco acreages, as well as feedstuffs; and Secretary Wallace states that it is time for farmers to "think primarily of their duty to consumers" and "fill up the storage bins." However, a return to normal crops upon wartime acreages, with little prospect of the export demand of that time, would depress farm prices all around; and Secretary Wallace is also occupied with his plans for an "ever-normal granary," which is a device for supporting prices in the event of over-production, in the hope that the crops could be reduced during the subsequent year by the exercise of centralized control.

All this is justified by the Secretary on the ground of maintaining the balance. But what will be the situation if the trend is a vicious circle of rising industrial costs and prices tending to reduce farm purchasing power, accompanied by the distribution of Government funds designed to uphold it? Is there any stable resting place for such a spiral, or would it go on to the inevitable crash?

To Restore Self-Supporting Business

The foremost of all reasons for emphasizing the unfavorable aspects of the rise in industrial costs and prices is that business is now working back toward a self-supporting basis. It must depend less hereafter upon continuous additions to purchasing power (of course at the expense of the future) provided through Government deficits, financed in part by an expansion of bank credit.

All business men know that Government money has been a great factor in the recovery, and all know that the expenditures must some time come to an end. When the increase in bank deposits attributable to Treasury operations is stopped the effect will be to halt the expansion of buying power, unless there is an equal or greater increase in private credit, or in the speed with which existing deposits circulate. This means that when Treasury expenditures are tapered off the general business situation must be sound, relations must be in balance, and inducements to private investment must exist; otherwise business will contract.

In this country the time is favorable for the turn from Government to private expenditures. The effort is to taper off the Government deficit, and if the intentions are realized Government borrowing except for refunding purposes will no longer be a major factor in the business situation. The prospect that private expenditures will make up for the drop, and more, is highly promising, in view of the outlook for investment in building and other capital equipment. However, it is imperative that no obstacles be put in the way of trade or investment. Excessive costs of building and capital goods would hamper improvement in that field, and too rapid rises in consumer goods would cause maladjustments threatening trade. If business is to become self-supporting and keep going ahead the necessary condition is that balance in price relations must be maintained.

Danger of Too Rapid Price Rise

The foregoing discussion concerns the danger that the business upswing may become unbalanced; and there is another hazard to be guarded against, namely, that the commodity price rise may get out of hand at a time when control and restraint are called for. If the general price advance is too rapid it is fairly certain to be unstable. A rapid price rise induces speculation, which is always an element of disorder, due to the miscalculations of the speculators. It is sure to affect different classes of goods differently, and to cause more serious maladjustments between prices than a gradual rise would cause.

There would be little present danger of the price advance running away if there were no restraints on production or barriers to trade, but the recent developments are disquieting. The strikes and the difficulty in obtaining skilled labor, due to the suspension of training programs during the depression, enforce temporary limits on production in some lines, and create "bottle necks" through which other industries are affected. Some industries are running at their practical capacity. In a few commodities restrictions on production have not been relaxed as early as desirable, due to the miscalculations of the authorities in control of the quotas.

All students of the economic situation have been concerned over the danger of inflationary price advances due to the world wide devaluation of currencies, the rapid increase in gold production, and the policies of governments in supporting unproductive economic activity by borrowing and spending. In this country the process of inflating or "reflating" purchasing power by Government borrowing from

the banks is evidently subsiding, but in other important countries it is still going on. Now Great Britain, which has kept her budget balanced throughout the depression, is joining in and will float loans to raise funds for armaments.

Undoubtedly the expenditures for armament in all countries, together with the accompanying speculation, exert a great influence upon the course of commodity prices. The metal markets in London have had a sensational rise, in the most active trading in many years, and markets in this country naturally have followed. Copper is up to 15 cents here (over 16 abroad), lead to 7¢, the highest since 1929, and zinc at 6.80¢ has duplicated its 1929 peak. These prices compare with 10 cents, 4.83, and 4.85, respectively, at the beginning of November, when the move started. Tin during the past month has risen from 49.80 to 55 cents, and the armament demand has been a factor in pig iron, steel and scrap, which is bringing the highest prices since 1925, in wool, hides, and even in wheat. Iron Age refers to a "world famine" in the ferrous metals, and it is certain that the steel industry in Great Britain and the Continent is running at capacity, with the effect that a share of trade is being diverted to this country.

For a discussion of the facts of armament expenditure and the questions involved our readers are referred to a later article in this Letter, but it is in order here to note the situation in these markets. Copper production is admittedly very profitable at 15 cents and there is a substantial reserve of mining capacity, especially abroad. All restrictions on the foreign production of copper have now been removed, and given time it is safe to say that production will increase to a figure considerably above any consumption known in the past. Moreover, the volume of speculation, as seen in the turnover in the London market, is a danger signal.

Business men should be prepared for a possible reaction in commodities which have been the medium for speculation or in which the shortage seems temporary, and if it comes should welcome it. The domestic markets are likely to be much less affected than foreign markets, and a reaction would not be expected to cause trouble here. The price rise and the stimulus to general activity, insofar as it is due to these factors, is plainly inflationary, and the whole situation will be improved if the markets return to a more orderly basis. The Board of Governors of the Federal Reserve System is concerned with the problem of keeping the recovery in hand, and obviously there is a far greater need for increased production than for higher prices.

Money and Banking

On January 30 the Federal Reserve Board issued its long-expected order raising the percentage of reserves that member banks of the Federal Reserve System must carry against their deposits. The amount of the increase was 33 1/3 per cent, applying to all member banks alike, with the provision—in order to afford banks ample time for adjustment to the changed conditions—that half of the increase would go into effect March 1 and the remaining half May 1. In the following table, we give a comparison of the reserve requirements effective on those dates, together with those previously in effect:

Reserve Requirements
(Per cent of Deposits)

	Demand Deposits			Time Deposits		
Class of Bank	Previous	Mar. 1 Thru Apr. 30	May 1 and Aft.	Previous	Mar. 1 Thru Apr. 30	May 1 and Aft.
Central Reserve City....	19½	22¾	26	4½	5¼	6
Reserve City....	15	17½	20	4½	5¼	6
"Country"	10½	12¼	14	4½	5¼	6

In a statement accompanying the order, the Board set forth at some length its reasons for taking action at this time. Reference was made to the huge inflow of gold, and to its effect upon bank reserves and deposits. It was pointed out that deposits already are substantially higher than in 1929, and far in excess of business needs. We quote in part as follows:

> Between the time of the banking holiday in 1933 and December 24, 1936, when the United States Treasury put into effect its program for preventing acquisitions of gold from adding to the country's banking reserves, the gold inflow aggregated approximately $4,000,000,000.
>
> This inflow of gold had the effect of adding an equal amount to the reserves of member banks as well as to their deposits. The total amount of deposits in banks and the Postal Saving System, plus currency outside of banks, is now $2,000,000,000 larger than in the Summer of 1929.
>
> The present volume of deposits, if utilized at a rate of turnover comparable to pre-depression levels, is sufficient to sustain a vastly greater rate of business activity than exists today. In order to sustain and expand recovery, the country's commerce, industry, and agriculture, therefore, require a more complete and productive utilization of existing deposits rather than further additions to the amount now available.

Origin of the Problem

It might be mentioned in passing that while the Board in its statement refers to the gold inflow as dating from the banking holiday, the records of the period show gold imports to have been very small (and largely exceeded by gold exports) until after the establishment of the 59 cent dollar on January 30, 1934. With the currency once more attached to gold—on a greatly devalued basis—gold commenced to pour into this country on a scale never before seen, and it has been coming ever since. An extraordinary opportunity had been offered to foreign investors to convert idle gold hoards

into American money at rates more favorable than ever had been known before. Not only was there a large repatriation of American capital previously exported, but foreign capital was sent over in enormous quantities to seek safety and profits.

To what extent this inflow of foreign money was the result of the devaluation of the dollar is a disputed question. According to some contentions, the conditions of uncertainty existing in Europe made a flow of capital to this country inevitable regardless of devaluation. No doubt this is true in a measure. Even so it is evident that the movement was greatly accentuated by our devaluation. The lower dollar cheapened our goods and equities in terms of foreign currencies, and so enhanced the attractiveness of our markets. Moreover, —and highly important,—the cheapening of the dollar was itself partly responsible for foreign internal difficulties that were promoting a flight of capital to this country. This was particularly true of the gold bloc countries, whose fate was practically sealed by the devaluation of the dollar, and from whom we received great quantities of refugee capital in the form of gold.

Finally, of course, it must be remembered that whatever gold was received after devaluation was counted at $35 per ounce, instead of $20.67, as formerly, which means that apart from the *quantity* of gold imports, devaluation was responsible for $1,600,000,000 of the $4,000,000,000 value of receipts mentioned by the Reserve Board, by virtue of mere write-up.

Pertinence Today

All this is history, but it is pertinent today because it shows the origin of the problem with which the authorities are now having to deal. The fact is that owing partly to world disorder and partly to the high price to which we have become committed, gold has been piling up in this country so fast that it is becoming more and more difficult to know what to do with it. Last Summer the Reserve Banks announced a 50 per cent increase of member bank reserve requirements for the purpose of impounding some of it in the banking system, and now they are in process of carrying out another increase to the same end. In December the Treasury commenced a program of borrowing money to buy and "sterilize" the new gold receipts. Such measures serve well enough for the present, but in the meantime the production of gold, under stimulus of the higher price, continues to increase at an unprecedented rate. And most of this new production is coming to America! Who can suppose that the Treasury will go on indefinitely borrowing money to lock up gold and hold it idle, particularly after interest rates advance, as they are likely to do some day? Evidently Washington also is in some doubt as to the adequacy of these measures, as witness the proposal now under discussion for keeping out gold by taxing foreign capital in this country.

How the situation will resolve itself is not clear. The fundamental trouble is that the world is paying too much for gold. Most economists predicted several years ago that this would prove to be the case, but with inflationary sentiment running high at that time few people paid any attention.

Official Explanations

In its statement of January 30, last, the Reserve Board points out that its latest order on reserve requirements completes the use of the Board's power in that direction, as provided by the Banking Act of 1935. The Board further states that it is not its present intention to ask Congress for additional authority to raise reserve requirements inasmuch as it expects by its present action to reduce excess reserves to the point where the control of credit may be effected through use of open market operations and the discount rate.

As for interest rates, the Board is at considerable pains to disclaim any intention of abandoning cheap money. It stresses the widespread distribution of excess reserves as facilitating the shift to a higher reserve base without strain. It estimates that, after the full increase of reserve requirements has gone into effect, member banks will have excess reserves of approximately $500,000,000, "an amount ample to finance further recovery and to maintain easy money conditions."

In further elucidation of its policies, the Board quotes from its statement issued last Summer in connection with the first increase of reserve requirements, as follows:

> The increase in reserve requirements of member banks will not diminish the volume of deposits held by these banks for their customers and will, therefore, not diminish the volume of funds available for investment.
>
> The maintenance of an adequate supply of funds at favorable rates for capital purposes, including mortgages, is an important factor in bringing about and sustaining a lasting recovery.

and goes on to say:

> The same considerations apply with equal force at the present time. The Board's action does not reduce the large volume of existing funds available for investment by depositors, and should not, therefore, occasion an advance in long-term interest rates or a restrictive policy on the part of institutional and other investors in meeting the needs for sound business, industrial and agricultural credit.

Testimony of Chairman Eccles

Similar assurance that basic credit policies remain unchanged have appeared in various unofficial statements emanating from the Treasury and the Reserve Board. While the Washington authorities evidently are prepared to see a moderate advance in short-term money rates, they profess to see little likelihood of any

change in the long-term rate. Testimony of Chairman Eccles of the Reserve Board before the House Banking and Currency Committee on February 17 was particularly interesting as indicative of views on money prevailing in official circles. Appearing on behalf of the Wagner bill to extend to June 30, 1939 the authority of the Federal Reserve Banks to issue notes secured by United States Government obligations, Chairman Eccles discussed the monetary outlook with considerable frankness. In connection with the Board's order to increase reserve requirements, the Reserve System head reiterated what the Board had said previously about the growth of deposits, and emphasized certain dangers in excessively cheap money that have impressed outside opinion for some time. He said:

> There is a tendency—a tendency on the part of institutional investors—to feel that the long-term rate is getting to a point where with a speculative or inflationary development they would likely take a loss or shrinkage on their investments.
>
> It is necessary to have confidence of the institutional investors in the long-term market, otherwise we will find these investors going into the field of speculation instead of long-term investment, such as mortgages, etc.
>
> In other words, when the rates on long-term investments get so low that the investors feel there is more speculation in that investment than in a stock, the money may be pulled from the capital market.

It can be added that such conditions involve a serious menace to the investor. The dilemma of the latter today is acute. Either he must load up with low coupon, high priced securities, with heavy sacrifice of current income and with certainty of eventual capital loss as interest rates advance, or he must take a chance with a lower quality of investments. For numerous individual investors dependent upon investment income, the only alternative lies in going into the more speculative field, and many are doing so who can ill afford it.

Referring to the recent increase of bank loans as a means of economic recovery, Chairman Eccles said that the Board expected substantially more activity in bank loans in the year ahead because of anticipated expansion of business.

It was on the subject of interest rates, however, that the Reserve Board Chairman's views attracted widest attention. "The long term interest rate," he said, "is not likely to go up in the immediate future, and, as far as I can see, in the indefinite future." He declared himself to be in favor of low long term interest rates, but conceded that the rate "will be largely determined by the total amount of savings of the country in relation to the demand for capital," which undoubtedly is right, provided there are no arbitrary attempts at regulation, or substitution of credit for capital. He also stated that he did not believe that the long term rate on Government bonds would go lower.

Short term money rates, on the other hand, he felt to be "excessively low" so that "there may be a tendency for rates near the vanishing point to increase."

Just how much too low, he did not say, though possibly an opinion to the effect that a rise in the open market commercial paper rate from three-quarters of one per cent to one and one-half per cent, and in the call loan rate from one to one and one-half or two per cent would be no deterrent to either business or the stock market, may be indicative of about what he had in mind.

Advances of Short-Term Interest Rates

Turning to the actual behavior of the money markets, we find short-term rates performing more or less as expected. During January a slight hardening had taken place in expectation of Federal action on bank reserve requirements, and the official announcement of forthcoming increases was the occasion of further slight advances. A measure of the firming of short money was provided by the average discount basis of weekly issues of Treasury bills which touched 0.401 per cent in the week of the Federal Reserve Board announcement, compared with 0.361 per cent at the end of January, and 0.084 per cent at the beginning of December. Subsequently, this rate eased off a trifle, closing the month at 0.386 per cent.

Rates on high grade short municipal and State issues firmed sympathetically with Governments, as for example, $100,000,000 New York State short-term notes, offered in February, carried interest at 0.50 per cent, as against interest at 0.35 per cent on $75,000,000 short-term notes offered in December.

Bankers' acceptance rates, which had been advanced fractionally in January, moved up another fraction early in January, and are now quoted 3/16ths above their extreme lows of last Summer. While no change took place in call loan and Stock Exchange time money rates during the month, rates on both these categories of loans passed their low points in 1935, and are now up ¾ to 1 per cent from the bottom. Only the open market rate on prime

Short-term Interest Rates, End of February And at Depression Lows

	End of February	Depression Low	
Call Money	1 %	¼ %	(Apr.-Oct. 1935)
Time Money, 60-90 days	1¼	¼	(Apr.-Oct. 1935)
" " 4 - 6 Mos.	1¼	¼	(May-Oct. 1935)
Commercial Paper, Prime, 3 - 6 Mos.	¾	¾	(Aug. 1935 to date)
Bankers' Acceptances:			
(asked) 90 days	5/16	⅛	(Oct. '34-July '36)
" 4 Mos.	⅜	3/16	(Apr. '35-July '36)
" 5 - 6 Mos.	½	5/16	(Apr. '35-Jan. '37)
Treasury Bills, 9 mos.	0.386	0.052	(July 17, 1935)

commercial paper remains unchanged at the depression low—¾ of 1 per cent.

In the table on the preceding page we present a comparison of short-term interest rates, currently and at the depression lows. Trends shown by the table, coupled with the expansion of business and the attitude of Government officials as expressed both in acts of public policy and published statements, confirm the general impression of a movement towards a more normal level of interest rates in the short-term field. This will be a good thing, in that it will strengthen the earning power of the banks and aid them in rebuilding their capital funds which will be needed to serve the increasing business of the country. Rates on many types of short-term money have been ridiculously low, and a moderate increase for this class of money will hurt no one.

Trend of Bond Prices

Chief interest, however, in the field of money rates has been in the action of the bond market, by reason of its significance from the standpoint of long-term interest rates. There is no doubt that the market for high grade bonds has had a rather uncomfortable time of it during the past two months, due to a variety of causes, including uncertainty as to the ultimate effects of pending increases of reserve requirements, talk of higher interest rates, and considerable congestion in new issues, with possibly the weakness of gilt-edge bonds in London exerting a psychological influence. In the following table we give samples of price declines running through four groups of representative high grade, long-term bonds, taking prices as of February 25 in comparison with 1936-37 high points.

Attention is directed to the relative steadiness of Government bonds,—a showing which, incidentally, was not duplicated by the notes, longer issues of which continued to show losses of over a point from the tops. High premium bonds, such as (generally speaking) the railroad group, and (among the municipals) the New York State 4s, gave ground easily, with decline in some high premium municipal and State issues not shown in the table running as high as 10 points at the most. The Dow-Jones index of 40 corporation bonds declined approximately 2 points from the December peak.

It may be said that both in high grade corporates and in municipals recent advances had been overdone, as evidenced especially by a condition in corporates where many issues were selling at prices yielding less return than Governments after allowance for tax exemption on the latter to corporate holders. The municipal market, in particular, has been suffering from a bad case of indigestion resulting from recent new issues, some of which have proved "sticky" and have necessitated substantial price cutting to get distribution. As the month wore on, the market generally displayed a much better tone, and considerable progress was reported in clearing away clogged up channels. Announcement by the Treasury that no new money would be asked for at the March 15 financing was a strengthening factor.

One of the bright features of the bond market was the favorable reception accorded an issue of $70,000,000 Republic of Argentina 4 per cent bonds at 91, this financing representing a further step in that Government's program of retiring its 6 per cent dollar debt and

High Grade Bonds—Prices February 25 Compared with 1936-37 Highs

	1936-1937 High	Mkt. Price 2/25/37	Net Change	Yield High	Yield 2/25/37
U. S. Government:					
2½s, 1953/49	101.22**	101.17**	—5/32	2.32	2.36
2¾s, 1954/51	103.17	103.17	*	2.45	2.45
3s, 1955/51	106.28	106.26	—2/32	2.43	2.44
2⅞s, 1960/55	104.29	104.29	*	2.52	2.52
2¾s, 1959/56	103.17	103.17	*	2.52	2.52
* New High.					
** Figures after decimals are 32ds.					
Rails:					
Atchison, Gen'l 4s, 1995	117¼	111	—6¼	3.33	3.55
Chesapeake & Ohio 4½s, 1992	128½	121	—7½	3.35	3.61
Norfolk & Western, 4s, 1996	124	118¼	—5¾	3.11	3.30
Pennsylvania R.R. 4s, 1948	116⅝	113½	—3⅛	2.23	2.63
Virginia R.R. 3¾s, 1966	109	104¾	—4¼	3.25	3.48
Utilities:					
Brooklyn Edison, 3¼s, 1966	105¾	102⅞	—2⅞	2.95	3.10
Consumers Power 3½s, 1965	108	104	—4	3.07	3.28
Detroit Edison 3½s, 1966	109½	104⅝	—4⅞	3.00	3.25
Ohio Edison 4s, 1965	108¼	104¾	—3½	3.52	3.73
Southwest Bell Tel. 3½s, 1964	110⅛	106½	—3⅝	2.95	3.13
Municipals and State:					
City of Cincinnati 2¼s, 1956	104	102⅜	—1⅝	2.00	2.10
Fairfield Cy., Conn. 1¾s, 1950	96½	94⅞	—1⅝	2.05	2.20
Boston Metro. Dist. 2¼s, 1957	100	96⅞	—3⅛	2.25	2.45
St. Louis 2½s, 1956	107⅞	105½	—2⅜	2.00	2.15
N. Y. State 4s, 1964	131⅝	124⅞	—6¾	2.40	2.70

substituting issues carrying a lower coupon. Proceeds of the new issue are to be used mainly for the purpose of redeeming two issues of 6 per cent bonds outstanding in the hands of the public to the amount of $64,100,500. In a generally reactionary market, the new Argentine bonds performed outstandingly, meeting with excellent distribution and holding a slight premium over the offering price following the dissolution of the underwriting syndicate. A heavy demand from foreign sources contributed to the success of the issue,—reflection in part of the large proportion of the Argentine dollar debt that has come to be held in European markets and also of widespread confidence in Argentine credit. During the past three years Argentina has made marked progress in economic recovery, resulting both in a strong market for Argentine Government securities listed abroad and in substantial inflow of foreign capital for internal investment.

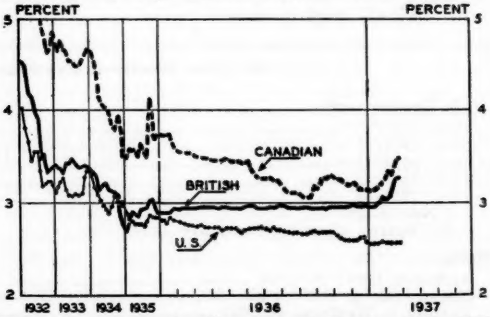
It is evident that there is a widespread perplexity among investors as to the future of long-term interest rates. With business expanding and promising to require more credit, and with short-term interest rates commencing to show a hardening tendency, there is a natural disposition to question how long it will be before the long-term interest rate is affected. At the same time there is recognition that the supply of funds is abnormally large, and is being constantly added to by the enormous and increasing output of gold to which we have already alluded; that short-term interest rates have been out of line; and that the Federal authorities remain committed to cheap money and have broad powers for making their policies effective.

Undoubtedly the situation is a confusing one, and is made more so by the existence of a "managed" money market in which changes do not take place by ordinary rule. Individuals can calculate for themselves what the natural forces will do, but they cannot calculate upon the action of arbitrary controls. So far, however, as the immediate future is concerned, there seems no reason to doubt that the situation lies wholly within the control of the authorities who have expressed themselves as well satisfied with things as they are. While it is quite possible that a certain amount of nervousness may prevail in the bond market until the adjustment of reserve requirements is carried out, it is difficult to envisage any general rise of interest rates so long as the supply of available funds, including bank reserves, is so largely in excess of the demand.

In sizing up the investment outlook, however, there should be no under-estimation of the enormous potentialities for expanding demands upon capital and credit that are latent in every period of rising prices. It is quite possible that these requirements may not be financed in precisely the same way as before, but bankers and other students of the money situation should not be misled on that account. Whether the needs of industry are met through direct commercial borrowing, through proceeds of private bond and stock issues, or through the borrowings and spending of the government, the effect upon the aggregate supply of funds is the same. What counts is the total demand for funds in relation to the total supply, and it is impossible to imagine any period of expansion and rising prices without an increasing demand for capital and credit.

Reaction in London Gilt-Edge Market

In considering the question of interest rates, mention should be made of the decided change that has come over the complexion of the London gilt-edge security market during the past two months. Taking the rate on British Government consols as an index of the market, it will be seen by reference to the accompanying diagram that the yield reached a low point around the beginning of 1935 at approximately 2.66 per cent. During 1935 it rose slightly to just under 3 per cent where it held fairly steadily all during 1936. Since the announcement of the Government's huge armament program, with its prospect of increased taxation and large Treasury borrowing, the market has been decidedly heavy, war loan 3½s and consols slumping 4 to 8 points, with yields in consequence moving up to the 3¼ per cent level. And, of course, as Government bonds have fallen, all other fixed-income securities have had to adjust themselves accordingly.



Yields on Long-term Government Bonds, 1932 - 1937

(United States Treasury 3s, 1951-55; British 2½% consols, and Dominion of Canada internal 4½s of 1949-59).

As an example of informed opinion on the outlook for interest rates in the British market, we quote from the London "Economist" for the week of February 13, as follows:

> We may conclude, therefore, that, so far as capital market records go, the downward movement in interest rates appears to have been arrested last year. The next few months will show whether this was merely a temporary development or the reversal of a well-established trend. Up to the end of last year, certainly,

the upward reaction in rates had not gone very far, and in almost every case our computations of average interest rates were well below the levels of 1934. Since the new year opened, however, the market for existing fixed interest securities has been depressed, and market values have fallen appreciably. This week's announcement of the Government's decision to seek power to borrow up to £400 millions for re-armament is obviously not calculated to help the gilt-edge market. It is reasonable to assume, therefore, that a resumption of large fixed interest borrowings in 1937 may well be associated with a further increase in the percentage yields offered to subscribers.

Capital Movements Following Gold Bloc Devaluation

Prior to the devaluation of the gold bloc currencies, the opinion was rather widely held that this step would result in a gradual repatriation of capital sent abroad and that foreign funds on deposit in New York or invested in gold in London would be the first to be taken back. Five months have now elapsed since France, Netherlands and Switzerland took the decisive step to devalue their currencies. Looking back over this period, it is evident that repatriation has followed an irregular course. While a considerable flow of capital to Switzerland and Netherlands has taken place, the modest return flow of capital to France dried up after a few weeks and then changed into a new exodus of funds. Disappointment with the course of recovery in France, budgetary difficulties and external as well as internal political complications, have all contributed to this new manifestation of the lack of confidence. The new outflow of capital from France, although discouraged both by the French authorities and by the governments of other countries, is believed to have caused a considerable drain on the French stabilization fund. The resources of this fund consist of 10,000,000,000 francs allotted from the revaluation profits. During the last month the French exchange situation was eased by the arrangement of a ten-month British credit to the French railways, amounting to £40,000,000 or 4,200,000,000 francs.

As a result of these mixed international movements and the continuously heavy stream of newly mined gold which has approached lately the $90,000,000 mark per month (Russia excluded), not only has there been no loss of gold on the part of the United States, Great Britain, Belgium and Sweden, the principal countries to which the fugitive capital retreated, but all of them have actually continued to gain gold during the post-devaluation period. Particularly embarrassing were the imports of gold to this country, aggregating since the devaluation of the gold bloc currencies almost $500,000,000, including gold contracted for prior to September 25th. We have referred previously in this Letter to measures already taken, or under consideration, for dealing with this inflow.

Operation of Foreign Stabilization Funds

London also has continued to gain gold, the net imports for four and one-half months following the devaluation of the gold bloc currencies amounting to almost $250,000,000. The exchange equalization fund, which was reported as already congested with gold prior to the devaluation, was subsequently called upon to absorb about £40,000,000 of French gold, representing the repayment of a loan extended to the French Treasury in February, 1936. Apparently to replenish its working assets, the fund sold to the Bank of England £65,000,000 (old parity) worth of gold, as revealed by the December 15 statement. Of this amount the Bank of England employed £60,000,000 to reduce the fiduciary issue, thereby increasing the credit base by only £5,000,000.

The Dutch equalization fund operates approximately as its English prototype. It was endowed with 300,000,000 guilders of Treasury paper, one-third of which was used for the purchase of gold from the Bank of Netherlands at the outset of its operations early in October. Since then the fund resold to the Bank gold to a total of 300,000,000 guilders to obtain the necessary means to continue its purchases of foreign currencies. As a result, the Dutch gold holdings have grown again to 870,000,000 guilders, a level exceeded only for a few months in 1932 and 1933. To discourage further influx of foreign capital and to retard the sale of gold from private holdings at home, the Bank of Netherlands lowered its buying price for gold by a small percentage.

The Swiss stabilization fund, like the French fund, was derived from the revaluation of the gold stock. To check the inflow of capital, the Swiss National Bank adopted shortly after revaluation a policy of buying gold only under special agreement, so that holders of gold in that country have no assurance that the Bank will take up their metal. Nevertheless, the Bank's gold holdings increased some $150,000,000 since the end of September and are now more than twice as large as the amount of Swiss Bank notes in circulation.

With the establishment of stabilization funds, all of which operate secretly, it has become increasingly difficult to trace the movement of capital. Changes in a country's gold holdings become apparent only when the supply of gold or Treasury paper in the stabilization fund approaches depletion and when the latter is forced to go to the central bank to obtain working assets.

Manufacturing and Trading Profits in 1936

A tabulation of the reports of some 940 leading industrial and trading corporations issued to date shows combined net profits, less deficits,

of approximately $1,624,000,000 for 1936, which compares with $1,076,000,000 for the same corporations in 1935 and represents an increase of 51.0 per cent. These corporations had an aggregate net worth of $16,017,000,000 at the beginning of last year, upon which the net profits were at the rate of 10.1 per cent, as against a return of 6.7 per cent in the preceding year. The accompanying summary of comparative profits, net worth and rate of return for the years 1935-1936 is classified according to the more important industries for which reports of a number of representative companies are available.

As has been pointed out in the past, the tabulation of a few hundred large corporations, which in this case have an average capital and surplus of $17,000,000 per company, is useful for indicating the general trend of earnings, but of course does not provide an accurate measure of the profitability of industry as a whole. The latter can be found only by reference to the official Statistics of Income compiled by the Treasury Department, which will be given later up to 1934, which is the latest report available.

Consideration should also be given to the large decline of industrial capital that has come about during recent years, due to the payment of wages, interest, dividends, taxes and other expenses out of capital and surplus as well as out of revenues, and to the heavy writing-down of fixed and current assets by large numbers of corporations, including those that were or still are in receivership or reorganization. The downward revaluation of assets tends to reduce operating and overhead charges and to permit book profits to be shown on a smaller volume of business than formerly, even though such reported "profits" are in a sense derived in part from capital. Moreover, even if the percentage rate of return upon net worth should recover to the 1929 level, the amount of profits in dollars would be considerably less because of the reduced capital base.

Changes in Different Industries

Last year, sharp gains in net profits were reported by many of the so-called heavy industries whose earnings curve had previously declined severely or gone into the red, such as iron and steel, non-ferrous metals, agricultural implements, electrical equipment, railway equipment, machinery of all kinds, office equipment, building materials, heating and plumbing supplies, hardware and tools, etc. Many automobile and accessory companies made an improved showing. There was a rush of buying in many of these lines last year to make up for the deferred purchasing during the depression period. In those lines in which profits declined most sharply, or changed into deficits, the percentage gains for one year to another during the period of recovery tend to be misleading and to exaggerate the improvement that has taken place, because of the low base on which they are figured.

More moderate gains were registered by companies in the consumers' goods lines, which declined much less during the depression or recovered sooner, including bakery, meat packing, sugar and other food products, tobacco, drugs, textiles and apparel, household goods and supplies, paper and petroleum. There were exceptions in the case of a number of industries, because of special circumstances prevailing, and of course the results of many individual companies ran counter to those of their own industrial groups. Numerous companies benefited last year by the rise in commodity prices and the resulting stimulation of forward buying of their products.

In the merchandising field, a majority of the statements of the larger companies that have been issued to date show an increase in profit last year, accompanying an expansion in sales volume. A group of 6 grocery chains, which always operate on a very narrow margin, made an average of only 1.5 cents net profit per dollar of sales in 1936 as compared with 1.8 cents in 1935. Some of the chain organizations handling general merchandise and specialties increased their profit margins as well as their volume last year, and many department stores, mail order and wholesale houses also reported gains. There was a considerable increase last year in the instalment sales of numerous classes of goods.

Comparison of 1929 with 1936

A comparison of the average rate of profit upon net worth for the years 1929 and 1936, based upon the reports publicly available up to the end of February of similar (but not necessarily identical) groups of leading manufacturing and mining companies, will show the extent to which the consumers' goods industries have recovered their earning power, and the lag in certain lines of producers' goods. The following listing is more or less arbitrary but will illustrate the difference in results:

Percentage Rate of Profits Return on Net Worth of Leading Industrial Corporations, 1929 and 1936

Producers' Goods	1929	1936	Consumers' Goods	1929	1936
Agricultural Imp.	16.7	17.5	Amusements	19.9	7.0
Automobiles	25.1	26.6	Apparel	11.7	9.6
Auto Accessories	24.4	19.3	Bakery	15.9	8.5
Building Materials	8.5	6.9	Cotton Goods	3.3	4.8
Chemicals	18.3	14.4	Drugs	21.8	25.6
Coal Mining	2.7	2.1	Foods—Misc.	13.9	10.8
Electrical Equip.	19.1	11.8	Household Goods	14.4	14.6
Hardware & Tools	15.7	13.0	Meat Packing	5.4	5.5
Heat. & Plumbing	14.3	8.5	Paper & Prod.	9.0	4.5
Iron & Steel	11.3	4.7	Petroleum	10.8	7.9
Machinery	15.4	12.1	Printing	26.8	12.0
Mining, Non-Fer.	16.1	8.4	Shoes	13.6	9.2
Office Equipment	21.2	12.6	Silk & Rayon	9.7	7.9
Paint & Varnish	13.8	11.6	Sugar	3.2	6.2
Railway Equipment	7.8	2.2	Textiles—Misc.	10.0	13.9
Rubber Tires	6.6	9.6	Tobacco	15.1	15.6
			Woolen Goods	—3.7	4.9

— Deficit.

PROFITS OF LEADING INDUSTRIAL CORPORATIONS FOR THE YEARS 1935 AND 1936

Net Profits Are Shown After Depreciation, Interest, Ordinary Taxes, and Other Charges and Reserves, but Before Dividends.

Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No.	Industry	Net Profits Years 1935	Net Profits Years 1936	Per Cent Change	Net Worth January 1 1935	Net Worth January 1 1936	Per Cent Change	Per Cent Return 1935	Per Cent Return 1936
8	Agricultural Implements	$12,529	$24,063	+ 92.0	$132,077	$137,617	+ 4.1	9.5	17.5
11	Amusements	10,556	16,636	+ 57.4	231,694	238,684	+ 3.0	4.6	7.0
24	Apparel	6,659	9,513	+ 42.8	105,381	99,489	— 5.4	6.3	9.6
11	Automobiles	199,413	301,920	+ 51.4	1,056,507	1,136,871	+ 7.6	18.9	26.6
32	Auto Accessories	12,393	18,096	+ 46.0	96,818	93,856	— 3.1	12.8	19.3
14	Bakery	15,046	22,633	+ 50.4	270,704	266,306	— 1.6	5.6	8.5
40	Building Materials	8,478	21,574	+154.4	318,201	310,545	— 2.4	2.7	6.9
22	Chemicals	106,360	142,440	+ 33.9	958,538	979,623	+ 2.1	11.1	14.4
10	Coal Mining	2,273	3,067	+ 34.9	149,661	146,526	— 2.1	1.5	2.1
14	Containers	42,242	42,578	+ 0.8	353,208	363,553	+ 2.9	12.0	11.7
42	Cotton Goods	D-8,845	10,368	+	230,956	216,494	— 6.3	......	4.8
10	Drugs and Sundries	25,002	27,018	+ 8.1	103,510	105,587	+ 2.0	24.2	25.6
25	Electrical Equipment	49,924	77,552	+ 55.2	646,163	657,678	+ 1.8	7.7	11.8
52	Food Products—Misc.	57,728	68,234	+ 18.1	641,449	634,486	— 1.1	9.0	10.8
23	Hardware and Tools	6,453	11,528	+ 78.5	86,775	88,589	+ 2.1	7.4	13.0
16	Heating and Plumbing	8,906	21,356	+139.7	249,251	250,441	+ 0.5	3.6	8.5
37	Household Goods and Sup.	31,338	44,240	+ 41.1	294,266	302,252	+ 2.7	10.6	14.6
44	Iron and Steel	52,443	152,744	+191.2	3,540,096	3,264,878	— 7.8	1.5	4.7
30	Liquors	11,547	15,293	+ 32.4	90,217	85,308	— 5.4	12.8	17.9
44	Machinery	8,172	18,298	+123.9	147,771	151,251	+ 2.3	5.5	12.1
16	Meat Packing	26,290	30,160	+ 13.7	556,542	550,905	— 1.0	4.7	5.5
8	Mdse.—Chains, Food	12,715	13,690	+ 7.5	144,921	145,785	+ 0.5	8.8	9.4
22	Mdse.—Chains, Other	58,093	66,503	+ 14.4	421,361	446,323	+ 5.9	13.8	14.9
15	Mdse.—Dept. Stores	4,052	10,389	+156.2	134,566	133,142	— 1.1	3.0	7.8
23	Mdse.—Wholesale, etc.	8,043	13,304	+ 65.4	116,760	124,325	+ 6.5	6.9	10.7
18	Mining, Non-ferrous	58,658*	75,184 *	+ 28.1	873,460	897,902	+ 2.8	6.7	8.4
11	Office Equipment	9,642	13,328	+ 38.2	109,796	105,541	— 3.9	8.8	12.6
9	Paint and Varnish	9,429	12,144	+ 28.7	105,949	104,251	— 1.6	8.9	11.6
26	Paper and Products	5,509	16,080	+191.8	355,271	359,059	+ 1.1	1.6	4.5
37	Petroleum	46,164	60,093	+ 30.1	743,860	756,728	+ 1.7	6.2	7.9
21	Printing and Publishing	11,756	13,806	+ 17.4	115,304	114,733	— 0.5	10.2	12.0
15	Railway Equipment	D-6,953	10,816	+	508,846	487,501	— 4.2	......	2.2
15	Rubber Tires, etc.	15,306	30,792	+101.1	311,286	320,155	+ 2.8	4.9	9.6
16	Shoes	13,926	14,379	+ 3.3	157,488	156,630	— 0.4	8.8	9.2
18	Silk and Rayon	8,161	9,480	+ 16.1	118,414	120,154	+ 1.4	6.9	7.9
22	Sugar	6,515	11,896	+ 82.4	186,081	192,360	+ 3.4	3.5	6.2
16	Textile Products—Misc.	9,163	12,515	+ 36.4	84,651	89,871	+ 6.1	10.8	13.9
19	Tobacco	59,619	75,169	+ 26.0	488,239	480,766	— 1.5	12.2	15.6
6	Woolen Goods	4,740	4,631	— 2.3	90,773	94,035	+ 3.5	5.2	4.9
54	Miscel. Manufacturing	50,179	68,331	+ 36.1	524,015	545,800	+ 4.2	9.6	12.5
44	Miscel. Services	6,248	12,254	+ 96.1	267,683	260,915	— 2.4	2.3	4.7
940	Total	$1,075,872	$1,624,095	+ 51.0	$16,118,509	$16,016,915	— 0.6	6.7	10.1

D — Deficit. * Before certain charges.

In some industrial groups, the addition of important annual reports that have not yet been issued would change somewhat the figures given above. Since the years 1929 and 1936 were both unusually profitable ones for many of these companies, the figures tell nothing as to the less favorable earnings and the deficits of the six years that came between.

The Economic Function of Profits

Profit rates of different industries and among different individual companies show extremely wide variations and are always changing. If the current and prospective profit rate in any one line appears to rise much above the average, this serves to attract more capital into that particular industry, until such time as increasing capacity and the resulting competition lower the rate of profit down to average, or below. Conversely, if any industry is earning a very low rate of return, or operating at a loss, new capital will probably not be attracted to it, but will turn elsewhere. In this way, the changes in profits naturally tend, if not interfered with, to direct automatically the flow of capital, labor and management into those industries in which they are needed to supply the apparent public demand. The economic laws of this profit-and-loss system permit a very flexible growth, and meet the requirements of financing speculative but promising new industries at the one extreme, to the withdrawal of capital from old industries that are drying up at the other.

New capital and competition always oppose any tendency toward "monopoly", and it is significant that in two of the major industries which have so often been accused of having

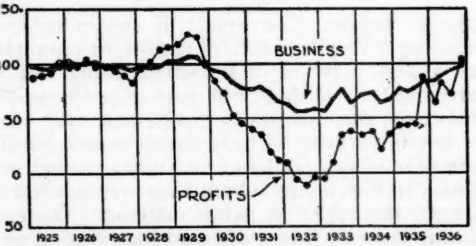
"monopolies"—iron and steel, and meat packing—the rates of return are among the lowest of those for some thirty different industries given in the table.

No system for the control of industry by some overhead or central authority has yet been discovered that can approach in effectiveness and efficiency the system of automatic control based upon profit rates, provided the natural system is permitted to function without too much outside interference. In a highly developed social system, the public desires goods and services of such infinite number and variety that it is impossible for any central bureau to have the information essential to control, even if its plans could be put into effect and could be enforced. Indeed, the managers of large and small businesses throughout the country spend a major portion of their time in studying the one question of what the public wants.

Quarterly Trend of Profits

During the course of last year, the trend of quarterly profits continued upward, with marked gains in the latter half of the year, reflecting the high rate of production and trade and the rising movement of commodity prices. The accompanying chart shows an index computed from the rate of return on net worth of the quarterly net profits of 200 leading industrial corporations, based on the 1926 average as 100 and adjusted for seasonal variation, together with the Annalist Index of Business Activity.

It will be observed that the profits index for the final quarter of 1936, which is preliminary, rose to above the base of 100 and stood at the highest point since 1929. As already noted, the decline in industrial capital and surplus during the intervening years has the effect of raising the percentage rate of return.



Quarterly Index of Industrial Corporation Profits and the Annalist Index of Business Activity. 1926 = 100

Inventories and Cash

One of the features of corporate balance sheets at the year-end was the rise in inventories that took place during the year, reflecting not only the increase in sales volume and the higher commodity prices prevailing, but also the tendency of manufacturers and merchants toward forward buying that is always manifest when markets are rising. Of a sample group of one hundred large industrial corporations, eighty-eight had larger inventories at the end of 1936 than a year earlier, and the total inventories of the group increased from approximately $1,323,000,000 to $1,502,000,000 or by 13.5 per cent.

It is interesting to note, however, that while the larger inventories resulted in a decrease in holdings of cash, U. S. Government and other marketable securities by forty-eight of the companies in this sample group, such holdings by fifty-two companies were actually increased. Total cash and marketable securities decreased from $827,000,000 at the end of 1935 to $791,000,000 at the end of 1936, or by only 4.4 per cent.

All Manufacturing Corporations

Although the foregoing figures taken from published statements of leading corporations indicate the trend of earnings, the actual rate of earnings for industry as a whole, including the thousands of smaller and less successful companies and those in receivership and reorganization, can be determined only from the official Statistics of Income, compiled by the Treasury Department from sworn and verified tax returns.

The accompanying condensed summary of all manufacturing corporations in the United States begins with the first report compiled in 1916 and carries up to the preliminary report for 1934, which is the latest available. The table shows the aggregate gross income from sales and other operations, the Federal and other taxes paid, statutory net income after taxes and deficits, and the percentage of net

All Manufacturing Corporations in the United States

(In Millions of Dollars)

Year	Gross Income	Taxes Paid	Net Inc. after Tax	Net Inc. to Gross	Net Worth	Net Inc. to Net Worth
1916....	$ *	$ *	$3,855	* %	$ *	* %
1917....	42,201	1,660	4,232	10.01	*	*
1918....	44,167	2,424	2,422	5.49	*	*
1919....	52,290	1,770	3,493	6.68	*	*
1920....	56,649	1,384	2,337	4.13	*	*
1921....	38,442	793	— 473	1.23	*	*
1922....	44,683	860	2,251	5.04	*	*
1923....	56,221	986	3,086	5.49	*	*
1924....	53,911	937	2,334	4.33	*	*
1925....	60,830	1,077†	3,154	5.18	36.067	8.75
1926....	62,495	1,139	3,124	5.00	42,366	7.38
1927....	63,723	1,065	2,580	4.05	46,273	5.58
1928....	67,273	1,118	3,366	5.00	48,050	7.00
1929....	72,132	1,161	3,862	5.35	50,017	7.72
1930....	58.650	952	801	1.36	52,695	1.52
1931....	44,033	731	— 988	— 2.24	52,122	—1.90
1932....	31,977	647	—1,906	— 5.97	47,640	—4.00
1933....	35,150	853	— 3	— 0.01	43,976	—0.01
1934-P	41,049	1,100†	713	1.74	43,342	1.65
Average 1917-34	$51,456	$1,148	$1,910	3.71	$46,255§	3.20§

Source: Compiled from annual Statistics of Income, Treasury Department. P— Preliminary. * Comparable data not reported. — Deficit. †Partly estimated. § Ten-year average, 1925-1934.

to gross income; also the aggregate net worth at the beginning of each year since 1925 and the percentage of net income to net worth.

For the eighteen-year period 1917-1934, the gross income of all manufacturing corporations averaged $51,438,000,000 per year, but ranged from $72,132,000,000 in 1929 down to $31,977,000,000 in 1932. Net income after taxes (but before dividends) fluctuated widely, ranging from a profit of $3,862,000,000 in 1929 to a deficit of $1,906,000,000 in 1932, but taking the good years with the bad, the average for the entire period was $1,910,000,000 per year. The latter figure amounted to only 3.71 per cent of gross income, meaning that 96.29 per cent of receipts was paid out for wages and salaries, materials and supplies, operating expenses and taxes, or charged to depreciation and reserves.

Except for the war years and the short boom that followed the close of the war, when reported profits were seriously inflated and were to a large extent wiped out by the subsequent slump, the margin of profit on sales ranged from a high of 5.49 per cent in 1923 down to a deficit of 5.97 per cent in 1932. The increase in dollar profits in the years leading up to 1929 was not primarily the result of wider profit margins, but rather of the expansion in sales, which permitted operations at a higher ratio of capacity and lowered unit costs. Even in the eight best years of prosperity, from 1922 to 1929 inclusive, the average profit margin was only 4.93 per cent.

This relatively small margin between gross income and total expenses is characteristic of business as a whole and particularly of large-scale business. Official returns show that even during the period 1922-1929, only about 60 per cent of all active manufacturing corporations in the United States, on an average, made any net profit whatever. In 1932, only 17 per cent of the total were in the black, and by 1934 the percentage had risen to only 37 per cent.

The difficulties and dangers facing the many thousands of concerns that even in relatively good years operate in the red, or on the borderline of profits, are intensified by any arbitrary increase in costs, whether for labor, material or taxes, which are beyond their control. In recent years there has been a sharp and continuous increase in the number and burden of the various business taxes, most of which have to be paid regardless of whether or not a business is making any net income. It is striking to note that taxes paid by all manufacturing corporations from 1917 to 1934 amounted to 60 per cent of the total reported net profit remaining to the shareholders for the use and risk of their invested capital.

Return on Invested Capital

The rate of manufacturing profits on net worth or shareholders' equity, after payment of interest on borrowed capital, is shown in the table to have ranged from 8.75 per cent in 1925 down to a deficit of 4.0 per cent in 1932, and to have averaged 3.20 per cent for the ten-year period, 1925-1934. This is not a high rate of return on capital that is subject to all the elements of risk, change and obsolescence inherent in the manufacturing industries. Moreover, the reported profits are undoubtedly over-stated, in that they do not take account of the special write-offs or revaluations of assets that are made from time to time to allow for insufficient depreciation, obsolescence, idle or abandoned plants, losses on inventories, receivables and investments, losses due to strikes, floods, etc., that are charged directly against capital and surplus but not against income.*

In the four years between the end of 1929 and 1933, the aggregate net worth of all manufacturing corporations declined from $52,695,000,000 to $43,342,000,000, or by $9,353,000,000. Of this decrease, $2,096,000,000 was caused by the net deficit and $6,631,000,000 by cash dividends paid out, leaving unaccounted for $626,000,000 of the decrease, plus whatever net investment of new capital was made for the purpose of strengthening capital structure during this period of depression. At the end of 1933, the aggregate share capital and surplus of American industry stood at the lowest point since 1926.

The Rise in Armament Expenditures

The appearance of the Chancellor of the British Exchequer before the House of Commons on February 11, asking for power to borrow up to £400,000,000 for defense purposes during the next five years, has brought very forcefully to the public attention the great growth of armament expenditures during the past few years. The British Government has already budgeted for defense services during this same five year period £1,000,000,000, to be spent at the rate of £200,000,000 annually. While the regular budgetary outlays are to be used chiefly for the aerial defense and the modernization of military equipment, the proceeds of the loan will be confined primarily to the building of battleships, naval and air bases, and armament factories. Great Britain, therefore, expects to spend about $1,500,000,000 annually for military and naval purposes in the next five years, which is about four times the amount spent annually before

* See Bulletin No. 62 of the National Bureau of Economic Research, Inc., dated December 7, 1936 and entitled "Revaluations of Fixed Assets, 1925-1934" by Solomon Fabricant, showing the excess of asset write-downs over write-ups during this ten-year period, based on a study of registration statements filed with the Securities and Exchange Commission by 208 leading corporations listed on the New York Stock Exchange.

the war and almost three times as much as was budgeted only three years ago.

Only a few days before the British announcement, the French Chamber of Deputies approved a special grant of 19,000,000,000 francs (about $890,000,000 at the present rate of exchange) for defense preparations to be spread over the four year period. This expenditure will have to be met from either a loan or a credit from the Bank of France. Its purpose is to provide for military roads, industrial mobilization, and particularly the extension of the concrete and steel "Maginot Line" of fortresses along the Belgian and Swiss boundaries. In addition, the 1937 French budget calls for a regular national defense expenditure of another 19,240,000,000 francs compared to 11,650,000,000 budgeted in 1933.

In the new 1937-38 Japanese budget, 1,400,000,000 yen (about $400,000,000) was allocated for defense services and although this figure was cut down somewhat in the Diet, it is still more than twice the military expenditures in 1931-32, the year of the Manchukuoan occupation, even if the subsequent yen depreciation is considered. Even this country, despite its comparative security from foreign attack, has increased its defense appropriations. In the 1937-38 budget, $992,000,000 was set aside for military expenditures against only $540,000,000 budgeted three years ago, the low for the post-war period.

The armament race is not confined to the great Powers alone. The smaller European countries and even the far-flung Dominions, Canada and Australia, have either budgeted or borrowed for rearmament. In January this year, the Netherlands proposed an extra expenditure of some 43,000,000 guilders for the East Indian Defense. The French credits and loan to Poland, fixed at 2,600,000,000 francs (about $121,000,000) is to be used primarily for mechanization of army equipment, for boundary fortifications and for strategic railways. Czechoslovakia, a comparatively small country, floated a huge defense loan of 3,500,000,000 crowns (about $120,000,000). Belgium and Switzerland are also engaged in fortifying their boundaries, while Turkey is doing likewise in the Straits. Reliable data are not available for the huge rearmament expenditures of Germany, Italy and Russia, but there can be little doubt about their size, particularly in Russia and Germany, where the entire national economy was mobilized for this purpose.

In a recently published survey, the Foreign Policy Association (Vol. XII, No. 23) attempted to measure the growth of rearmament costs since Japan's conquest of Manchukuo. According to this survey the defense expenditures of 60 countries rose from $5,064,000,000 in 1934 to $10,730,000,000 in 1936 and will likely be even higher during 1937. Expenditures of these proportions, of course, have greatly influenced the industrial production of a number of countries. In fact, the French Premier remarked in his Lyons speech in January that in many countries "it would be impossible to restrict the present armament race without provoking the danger of grave internal crisis."

Expenditures Approaching War Totals

Defense expenditures of European countries are already approaching the war scale. As much as 20 per cent of the national income, or over 50 per cent of ordinary tax income, is being diverted in some countries into unproductive channels for war equipment. This is because an armament program requires nowadays vast expenditures of capital not only for the maintenance of armies or fortifications as in the past, but also for building of manufacturing plants capable of turning out the latest models of tanks, motor vehicles and airplanes. Moreover, vast reserves of foodstuffs and essential raw materials have to be put aside, because no country wants to be caught short after the experience with the blockade in the last war.

Hence, the diversion of a large portion of the national income becomes imperative, unfortunately at the expense of consumers and private business in general. Not only must private business compete for what is left from the annual accumulation of capital, thereby forcing the cost of capital upward, but it is also forced to compete for raw materials and skilled labor, particularly if business revival happens to take place concurrently. Under these circumstances artificial demand is created for commodities, resulting in higher prices, while scarcity of labor or of productive capacity brings about "bottle-necks" in the industrial machine. Naturally, industrial costs rise, and the export trade becomes handicapped and neglected. In turn the husbanding of foreign exchange may become necessary along with the control of imports. In such event raw materials for rearmament usually receive precedence over the imports of foodstuffs or raw materials for private business, although they do not produce anything for export in return. Thus the armament expenditures not only do not add anything to the material well-being of a country, but inevitably depress the standard of living of its population.

The consequences are even more serious if borrowing has to be resorted to in order to defray the cost of armaments. In such case an inflation of bank credit takes place, which may become particularly unsound if the credit base had been already over-extended as a result of previous borrowing for social needs or business revival. The additional purchasing power

which is thus created only intensifies the pressure for certain commodities, industrial capacity and skilled labor. A temporary boom in unproductive capital goods takes place at the expense of consumption goods, only to augment the taxpayers' burden. Moreover, the difficulty of keeping the country's economy balanced becomes greater and invites more government control and interference for the purpose of counteracting the effects of its own policies.

National Defense Expenditure of the World

(In Millions of Dollars)

	At 1913 Parity		At 1936 Parity		
	1908	1913	1931	1934	1935
North America (3)	$ *	$ *	$ 745	$ 749	$1,005
United States	*	245	708	710	965
So. & Cen. Amer. (19)	*	*	127	190	179
Europe (29)	1,455	2,365	2,749	3,520	8,880
Great Britain	287	375	449	481	847
France	214	399	695	583	716
Germany	287	487	247	382	2,600
Italy	88	141	272	264	871
Soviet Union	291	448	281	1,000	2,965
Cen. Eur. & Balkans } Others	288	515	472	498	526
Others			335	313	357
Far East (6)	*	*	415	574	634
Japan	*	92	132	272	307
China	*	*	88	113	95
Others	*	*	195	189	232
World Total (60)	*	*	$4,067	$5,064	$10,731

Note: This table represents only an approximate comparison between different countries, as changes in currency value, internal purchasing power and governmental policies make accurate comparison impossible. Conversion rates are taken principally from United States Department of Commerce, Commerce Reports, January 9, 1937. *Comparable figures not available.

Source: Reports of Foreign Policy Association, Vol. XII, No. 23 and Vol. X, No. 17. P. Jacobsen: Preparatory Memorandum for the Five-Power Naval Conference (League of Nations—reprinted in the London Economist, October 19, 1929.)

Unreal Prosperity

It should be unnecessary to say that this is a very unwholesome and undesirable development in world affairs, but unfortunately the news reports commonly imply that it is a boon to the business community. It is indeed increasing the demand for labor and causing a rise of prices, as similar developments did after the outbreak of the Great War. However, the world knows by this time that the activity in industry produced by that War meant anything but real prosperity. It was the most reckless, profligate and disastrous expenditure of capital, labor and credit ever known in the history of the world, and cost all nations nearly twenty years of normal development, not to mention the debts still remaining to be paid.

This armament race means that, except for the armies in the field, the costs of the Great War are being repeated and that the deadly influence of inflation already is felt in the business life of all countries. Although the national debts created by the Great War have been scarcely reduced at all, and for most nations have been increased; although the taxes levied during that War have been reduced but little, and are now being increased; although the normal pre-war rate of industrial growth has not yet been regained, these new burdens are being assumed under the pressure of seeming necessity.

It is now known as a self-evident truth that the disorganization of industry and trade, the violent fluctuations of prices and wages, and the resulting calamity of widespread unemployment, have been, together, the principal cause of the Great Depression that has encircled the world and that has been more costly than the War itself. These vast expenditures upon war preparations must have a similar influence, so far as they go.

All of the panics, crises and depressions the business world has experienced in the past have been caused by disturbing influences arising outside of normal industry and trade, and in most instances from War. The revenues raised by taxation and expended upon armaments might as well be thrown into the sea, so far as any lasting benefit to the mass of the world population may result, and the same is true of the proceeds of loans for this purpose. The immediate effects upon wages and prices must result, as before, in derangements of trade relations, with another period of unemployment and a long struggle with debts.

True and lasting prosperity results only from regular and balanced production of goods that minister to the needs and welfare of the masses, and a reciprocal trade which enables the varied individual groups to buy from each other in mutually beneficial trade. Such trade, if it settles itself, may continue indefinitely, in ever-growing volume for it is obvious that we have not even approached the satisfaction of all wants. A war-boom is destructive of wealth, and mortgages future income, while reciprocal trade in goods for consumption or use is a blessing to mankind.

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